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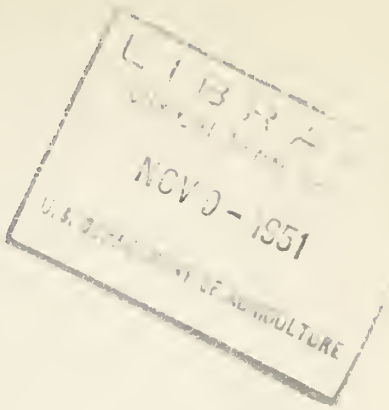

QUARTERLY SUMMARY OF CASES
RELATING TO
FARMERS' COOPERATIVE ASSOCIATIONS

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Prepared for the

COOPERATIVE RESEARCH AND SERVICE DIVISION

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COOPERATIVE RESEARCH AND SERVICE DIVISION

Summary No. 51 September 1951

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COOPERATIVE HELD ON THE FACTS NOT BOUND TO PAY ALL MEMBERS UNIFORM PRICE FOR MILK THOUGH ALL MILK COMMINGLED AND SOLD AS SO BLENDED

On May 24, 1951, the Court of Appeals of the State of Maryland rendered a decision in the case of Cooperative Milk Service, Inc. v. Hepner, et al., 81 Atl. (2) 219. The opinion of the Court reads in part as follows:

"This is an appeal from a decree that defendant account to plaintiffs for the difference between the respective amounts paid to plaintiffs for milk shipped by them through defendant between February 1, 1950 and July 15, 1950 and the amounts they would have received if they had been paid the average prices per hundredweight received by all who shipped through defendant for all milk shipped during that period.

"Defendant, Cooperative Milk Service, Inc., the Cumberland association, is a cooperative association incorporated in 1948 under the Maryland cooperative associations act. Code, Article 23, sections 430-458. Among its purposes and powers (each stated to be both) are, 'To engage in any activity in connection with producing, marketing, selling, preserving, * * * packing, handling, storing or utilization of any agricultural products of its members; * * * or in any one or more of the activities specified in this Article, and to transport the products of its members, * * *', and 'To distribute to the patrons, members and nonmembers alike, the proceeds of the business of the Association after payment of all necessary expenses and authorized deductions to the members in proportion to the volume of business transacted by such patrons with the Association.'

"Defendant entered into a marketing agreement with each of its members and other producers, for a term of two years and until terminated by either party, whereby defendant bought and the producer sold to defendant all milk and milk products produced by the producer, to be delivered at such place or places as defendant might direct. By the agreement defendant was authorized 'to establish from time to time, daily, weekly, monthly, or seasonal pools of the agricultural products marketed by it of the same variety, grade and quality, and all producers having such products in a particular pool shall share ratably in the net amount received therefrom.' and it was provided, among other things. that 'this agreement is one of a series dependent for its true value upon the adherence of each and all of the contracting parties to each and all of the said agreements, but the cancellation of this agreement or the failure of the Producer to comply herewith shall not affect other similar agreements.', that 'the Articles of Incorporation and the By-Laws, now or hereafter in effect, and this agreement

constitute the entire agreement between the Association and the Producer.' and that defendant might 'enter into agreements with other producers differing in terms from those contained herein but consistent with the By-Laws of the Association without invalidating this agreement, provided that the Producer at his request may sign a similar agreement as a substitute for this agreement.'

"In April, 1948, defendant purchased the Cumberland milk receiving station of the Embassy Dairy (James J. Ward) of Washington, D. C. From May 1, 1948 till June 30, 1949 defendant sold its milk to Embassy Dairy, receiving the 'Blend Price', which is considerably higher than the 'Manufacturers' Price' paid for milk to be sold to ice cream manufacturers and others. During this time defendant was actively engaged in trying to find another market for its milk because of uncertainty of the situation in Washington. From a survey it had found that of all milk outlets on the eastern seaboard the Washington market paid the highest blended milk price. Eighty-five per cent of the milk distributed in Washington was distributed by Maryland and Virginia Milk Producers Association, the Washington association. The Washington association was interested in securing a new milk shed in the Cumberland area. Like Washington prices, Washington requirements for qualification of producers are high. During the war, on account of milk shortage, these requirements were relaxed, and temporary Health Department permits were issued to producers, including members of defendant, who could not qualify under the strict Washington requirements. These requirements relate not only to tests of milk itself, but also to buildings and other conditions of production. New construction or reconstruction to comply with these requirements might be costly. Some of defendant's members were financially unable to incur such expense or considered that it would not pay to do so. Cancellation of temporary permits loomed ahead in the indefinite, but not remote, future.

"In the spring of 1949 defendant negotiated with the Washington association regarding use of the Washington association as an outlet for defendant's milk. The matter had been brought to a head in April, 1949 when Embassy Dairy notified defendant that on and after April 18th all milk in excess of 3,000 gallons a day would be paid for on the basis of only $2.50 per hundredweight, which was approximately the manufacturers' price. This reduced the average price for all defendant's milk, received by each of its members. The Washington association advised defendant that it was not willing to accept milk and pay the blend price for it unless the milk came from shippers who were its own members and with whom it had a marketing contract, but was interested in securing members in the Cumberland area and would be willing to buy from its own members who might use defendant's receiving station as a receiving station.

"Before June 18, 1949 negotiations between defendant and the Washington association had led to sharp difference of opinion among defendant's members. In a letter from defendant's secretary to its stockholders, dated July 15th, it was said, 'Your officers have contacted most of the membership and find that a majority of the members desire to market their milk through the Washington Association and these members produce over half the milk of the Association. In view of the fact that the Association does not have any definite contract with any other outlet, it is the opinion of the Board that it would be to the best interest of the producers and the Association that arrangements be affected[sic] whereby members who desire to do so and are eligible may market their milk through the Washington Association. To effect this, the Board of Directors is willing to cancel the marketing contract of all members who wish to market their milk through the Maryland and Virginia Milk Producers Association, Incorporated, upon the express condition that the members so cancelling shall remain members of the Association and agree to use the plant of the Association as a receiving station for their milk and shall give the Association an assignment of part of their account with the Washington Association to cover the cost of [handling?] and shipping their milk. * * * The Association will continue to market milk of any members who do not wish to market their milk through the Washington Association. As long as the District of Columbia permits milk from this area to enter Washington under a temporary permit, milk of all members of the Association who are not members of the Washington Association will be sold to the Washington Association. It is your Directors' hope that the Washington Association will continue paying a blended price for this milk as they are at present. When the District of Columbia cancels its temporary permits, the Association will arrange for other outlets of the milk of its members who do not market it in Washington and secure for them the best price obtainable. The Association wishes to emphasize that the plan now being put into effect will not deprive anyone of a market for their milk. It merely gives all members a chance to market their milk in the Washington area and secure the best price obtainable for their milk. Since the temporary permits for milk from this area will probably remain in effect for several months longer, those members who at the present time are not [eligible] to go into Washington market will have an opportunity to raise their standards and take advantage of this market.'

"At a meeting of stockholders, in accordance with the statute, art. 23, sec. 434, at which fifty-two members were present, amendments of the charter and the by-laws were adopted, and also, by a vote of thirty-seven for to fourteen against, a resolution authorizing the directors 'to cancel the present marketing agreement of any member of the Association for the purpose of permitting such member to become a member of the Maryland and Virginia

Milk Producers Association, Inc., and market his milk through such Association, upon the express condition that such member shall enter into a patron's agreement with this Association whereby the Association will act as a receiving station for his milk, and such member shall assign part of his monthly account with Maryland and Virginia Milk Producers Association, Inc., to cover the cost of operating expenses in connection with such receiving operation, and to provide capital for the Association.' The minutes of the meeting state that the president, among other things, 'emphasized that if Mr. Ward, of the Embassy Dairy, was correct in his statement that the temporary permits for Washington would not be removed for three years, the milk of every member of the Association would be marketed in Washington as long as the temporary permit was available, and that those members of this Association who were non-members of the Washington Association would receive the blended price for their milk, and this blended price was higher than any other price obtainable in the area. He went on to point out that if the temporary permits were revoked, then the Association would market the milk of members who were not members of the Washington Association in accordance with their contracts, but could not handle this milk through the local station. If they had enough milk to warrant leasing or building an additional receiving station, they would consider doing so.' [Italics supplied.] The charter amendment adopted was the insertion, in a provision denying rights or vote to a stockholder who 'has not for a period of twelve months marketed his agricultural products through the association', of the words 'handled, processed or shipped' after 'marketed'. Of the by-law amendments one was the same as the charter amendment, one changed a mention of 'marketing business' to 'marketing or other business', one declared that the directors shall have power to authorize agreements of the association 'with its patrons for the marketing of their milk, for the handling, cooling and shipping of their milk and for any other purpose permitted by the charter and by-laws', and one declared that 'the association may simultaneously engage in any of the activities set forth' in the charter.

"Defendant's members who became members of the Washington association each executed with defendant (1) a 'memorandum of agreement' by which defendant cancelled the member's previous marketing agreement and he agreed to designate and use defendant's Cumberland plant as a receiving station for his milk, to assign to defendant part of his monthly account with the Washington association, and to sign a patron's agreement, (2) a patron's agreement by which defendant agreed 'to receive, cool and store' all milk delivered to its plant in Cumberland by him and 'to transport same and deliver it' to Washington or elsewhere as directed by the Washington association, and he agreed to assign to defendant such amount from his monthly account with the

Washington association as might be necessary to cover (a) costs of handling and transporting, (b) expenses, including interest and dividends on capital, (c) capital revolving fund, not to exceed fifteen cents per hundredweight of his milk handled and (d) capital reserve, not to exceed five cents per hundredweight, and (3) the assignment from his account with the Washington association. They each also executed a marketing agreement with the Washington association. The members of defendant who were also members of the Washington association constituted a majority of the members of defendant but a small minority of the members of the Washington association.

"Defendant continued to collect the milk of its members who did not become members of the Washington association and sold it to the Washington association. This milk was commingled with the milk of members of the Washington association and was transported in defendant's tank trucks to Washington or other points designated by the Washington association. Each month the Washington association sent defendant a check covering the purchase of this milk at the Maryland blend price, and defendant in turn paid these members their pro rata share, less costs, expenses and capital 'retains'. The Washington association paid directly to its members the price for their milk, less the assigned deduction paid to defendant. Only members of the Washington association who had Washington permits received the Washington blend price, which was five cents more than the Maryland blend price. Only members of the Washington association received the 'seasonal adjustment payment'. As neither plaintiffs nor defendant make any point as to the seasonal adjustment payments or the difference between the Washington and Maryland blend prices, we need not explain or further mention these payments or this difference.

"On January 18, 1950 the Washington association notified defendant that on February 1st the Washington association would discontinue purchasing milk from defendant at the blend price and would pay only the manufacturers' price. On the same day the Washington Board of Health announced that all temporary permits would be cancelled as of June 30, 1950. This date was later extended to September 1, 1950 and, we were informed at the argument, was again extended to November, 1950. On January 20th defendant wrote its members notifying them of both of the actions mentioned.

"Two of the plaintiffs say that in August, 1949 they asked to be released from their contracts with defendant, but were refused. One says he then had another market available. Defendant's president says it cancelled no contracts before about September 15th or October 1st, because if it cancelled, it would have to give everybody the same privilege; about that time it cancelled the contracts of those who became members of the

Washington association, and it did not stand in the way of anybody else who wanted to quit. In February, 1951 the blend price was about $5 per hundredweight, the manufacturers' price about $3. Defendant made the same charge of 80¢ per hundredweight (60¢ for expense and 20¢ for capital) for the $3 milk sold by it to the Washington association and for the $5 milk transported by it for members of the Washington association. Both the milk sold and the milk transported continued to be mingled. The prices and the price differential varied from month to month, the differential ranging from about $1.50 to $2. Some of the plaintiffs say the manufacturers' price, less deductions, was less than their cost of production. Defendant says it could find no better market for its members who were not members of the Washington association. Such members were not numerous enough or their supply large enough to warrant construction or acquisition of a new receiving station by defendant. As fast as they found other markets, they gave up their contracts with defendant and sold elsewhere. By July 16, 1950 not one non-patron member was selling to defendant.

"On April 14, 1950 plaintiffs filed their bill for an accounting. Of the eleven plaintiffs eight attended the stockholders meeting on August 22, 1949, and presumably voted against the action there taken. Of the five plaintiffs who testified all except one, who was not present, voted and also voiced their opposition at the meeting. Three of the plaintiffs, who happen to be the three who did not attend the meeting, were held entitled to no relief, because they had executed releases when they gave up their contracts. The other eight by the decree below were held entitled to the accounting awarded.

"Plaintiffs contend, and the lower court in effect held, that defendant's action constituted a breach of trust, and was illegal under its charter and by-laws and under the cooperative associations act, under its marketing agreement with plaintiffs, and under 'general cooperative law and practice'.

"Cooperative associations differ from ordinary business corporations principally in that they do most of their business with their own members. Art. 23, sec. 430. Among statutory differences are limitation of members to one vote each (ibid.) and prohibition of voting by proxy, art. 23, sec. 447, with a narrow exception. Art. 23, sec. 450. It may be doubted whether an ordinary business corporation, if and when it deals with its stockholders as such, is under any less duty of fairness and equality than a cooperative. Stockholders are not trustees or quasi trustees for each other. Shaw v. Davis, 78 Md. 308, 318, 28 A. 619, 23 L.R.A. 294. But when majority stockholders use their voting power for their own benefit, for some ulterior purpose adverse to the interests of the corporation and its

stockholders as such, they thereby become fiduciaries and violate their fiduciary obligations.

"Not unnaturally plaintiffs felt that injustice had been done when their milk was commingled in the same tanks with other members' milk and they received $3 per hundredweight for their milk and other members received $5. The lower court in its opinion, referring to defendant's members who were not members of the Washington association, said, 'In fairness to them, and in fairness to the local Coop, the Washington Association should have continued to pay the blend price to all until the temporary Washington permits were actually revoked.' Against this view it may be said for the Washington association that impending cancellation of the temporary permits, which threatened plaintiffs with loss of a market, also threatened the Washington association with loss of part of its supply. The Washington association, therefore, paid the highest price to producers who had become its own members and had fitted themselves, or would fit themselves, to continue to sell in Washington after cancellation of the temporary permits. If, however, we should unite--for rhetorical purposes only, since the Washington association is not a party to this case and we cannot make a decree against it--in the lower court's condemnation of the Washington association, the question would still remain whether defendant did anything unfair or unlawful to bring about the result.

"There was nothing unfair or unlawful in anything done or left undone by defendant after the announcement of price reduction in January, 1950. Defendant may have been dominated by members of the Washington association, but the Washington association was not dominated or controlled by defendant or its members, and there is no evidence that the Washington Health Department was controlled by either defendant or the Washington association.

"Plaintiffs contend that defendant's original action in the summer of 1949 in authorizing release of marketing agreements and substitution of patron's agreements with its members who became members of the Washington association was unfair and unlawful. Plaintiffs say that defendant's duty of equality in treatment of its members limited it to one uniform contract with all its members for a single activity. Early statutes in other states, or narrow charter purposes or powers under the Maryland act, might furnish support for such a contention. In the instant case this contention is contrary to the statute, to defendant's charter and to the marketing contract itself. The act provides that each association shall have power 'To engage in any activity in connection with producing, marketing, selling, preserving, * * handling, storing, or utilization of any agricultural products of its members; * * or in any one or more of the activities

specified in this sub-section and to transport the products of its members * * *.' Art. 23, sec. 437. Manifestly, this provision does not restrict defendant to a single activity. For present purposes, the provision above quoted from defendant's charter is no narrower than this provision of the act; the two provisions are practically identical. Cf. California Canning Peach Growers v. Harkey, 11 Cal. 2d 188, 78 P. 2d 1137; Packel on Cooperatives, (2d Ed.) §§ 11(d) and 43.

"The by-law amendment declaring that 'the association may simultaneously engage in any of the activities set forth' in the charter was not necessary to remove any previous restriction, and added nothing to the powers of the association under the statute and its charter. The other by-law amendments and the charter amendment merely broadened some words in subsidiary details and were not needed to remove any previous restriction upon the statutory and charter powers of the association. It is therefore unnecessary for us to consider the scope of the power of charter and by-law amendment conferred by statute and at least recognized in the marketing agreements. The marketing agreement also, in a provision above quoted, expressly provides that defendant may 'enter into other agreements with other producers differing in terms from those contained herein * * * provided that the Producer at his request may sign a similar agreement as a substitute for this agreement.'

"We may assume that defendant could not lawfully make any arbitrary discrimination between its members, e. g., between those who were and those who were not members of the Washington association; that it could not benefit one class at the expense of another by giving more favorable terms to one class, knowing that the other class was not able to take advantage of such terms. The defendant did not make any such discrimination. Defendant did nothing to create the conditions which gave members of the Washington association any advantage over its other members. All its members were faced with loss of the Washington market through enforcement of the Washington requirements of milk producers. This market could be saved by defendant's individual members by complying with the Washington requirements, and to this end becoming members of the Washington association. Defendant was not under any duty to let all its members drown because some of them could not swim and either could not afford the cost of learning or did not consider the cost of learning worth while.

"Plaintiffs say defendant's action was unlawful because of the 'assurances' given them that the blend price would continue to be paid until cancellation of the Washington temporary permits. The 'assurances' referred to are the above quoted statement in the letter of July 15, 1950 and the above quoted and italicized

statement by defendant's president at the stockholders' meeting on August 22nd. The difference between the two statements is that what is stated in the letter as a hope, was stated at the meeting as a fact or (to speak more accurately) a prediction. Plaintiffs do not contend that this statement was made fraudulently, with intent to deceive. The lower court finds that defendant's officials 'were led to believe this purchase of all its milk at the "blend price" would continue until the temporary wartime permits were revoked by the Washington Health authorities.' There is no evidence that defendant in bargaining with the Washington association could have obtained any undertaking that such purchase would be so continued. The testimony, and the interest of the Washington association in getting new members, indicate that it would not have given such an undertaking.

* * * * * * *

"Decree reversed, with costs, and bill dismissed."

(R. D. Burchard)

Some of the conclusions enunciated by the Maryland Court in this decision should be of considerable interest to cooperatives generally. The Court, for example, ruled that it could not see anything in the Maryland statutes, in the defendant association's charter, or in its marketing contract, to justify the contention that the organization's "duty of equality in treatment of its members limited it to one uniform contract with all its members for a single activity."

The broad view of the Court on operating freedom and flexibility probably will be welcomed generally with approval by cooperative leaders. Aside from the rather complicated details of this particular case, however, some doubts would surely arise as to whether equity was properly served in any situation where a cooperative actually paid two rates of return simultaneously for identical products, unless some specific justification for the difference were involved.

(George J. Waas)

WRITTEN CONTRACT BETWEEN COOPERATIVE AND PATRONS FOR DISTRIBUTION OF PAYMENTS HELD MODIFIED BY SUBSEQUENT CONDUCT OF PARTIES

On April 26, 1951, the United States Circuit Court of Appeals for the Ninth Circuit rendered an opinion in the case of Matanuska Valley Farmers Cooperating Association v. Monaghan, 188 F. 2d 906.

The Court ruled that certain provisions of a written contract had been modified by the conduct of the parties so that they were no longer enforceable. Accordingly the case was decided in accordance with what the Court held to be the contract as amended.

The opinion is in part as follows:

"ORR, Circuit Judge.

"Appellant (hereinafter referred to as the Cooperative) appeals from a judgment enforcing the terms of a written contract, the provisions of which, the Cooperative contends, do not govern the relations of the parties.

"The Cooperative is a corporation organized under the laws of Alaska for the purpose of buying, selling, handling and processing agricultural products on a cooperative basis for the benefit of its shareholder-members. The members agreed to sell to the Cooperative, and the Cooperative agreed to purchase, all the produce of the members. Such materials as were needed in the handling and processing of the produce which were not supplied by the members were purchased by the Cooperative from other persons. In addition, the Cooperative maintained consumer departments, selling to the members goods purchased from the members or from others. For purposes of administration, the various aspects of the business were broken down into 'departments', namely, the Dairy Creamery Department, the Produce Department, the retail store, etc.

"The producing departments purchased the produce of the members, processed it if necessary, and resold it. Ordinarily, the produce of any individual member would be mingled with like produce of other members, so that it was impossible to allocate to the produce of any individual member the proceeds from the resale of his produce. For example, potatoes would be mingled with potatoes, and milk with milk. On the other hand, the produce of an individual member would not be mingled with unlike produce. Hence, a determination could be made as to the proceeds from the resale of the produce allocable to each type of produce subject to expenses incurred in handling and processing. The operation of the consumer departments was in all relevant respects analogous to that of the producing departments.

"Appellee is a dairyman, or milk-producer, and the assignee of others similarly situated. These dairymen sold milk during the fiscal year 1945 to the Dairy Creamery Department and were paid twice a month on the basis of the amount of milk thus produced. They instituted this action to recover additional payments allegedly due for such milk. The trial court decided the case on what it deemed to be the requirements of the written contract. We think that contract was, subsequent to its execution, modified by the acts of the parties and by mutual consent.

* * * * * *

"The District Court concluded that Paragraph 7 was applicable and relied on the testimony of certain of the dairymen that they understood they were to be paid in accordance with Paragraph 7; also, the testimony of at least one of the former officers of the Cooperative that the Cooperative had endeavored to follow Paragraph 7 as closely as possible. The District Court adopted the accounts of the Cooperative (prepared for the purpose of allocating the net profit of the Cooperative, as hereinafter shown) to reflect the income and deductions attributable to the Dairy-Creamery Department under Paragraph 7. Thus, the dairymen were considered entitled to the entire book profit credited to the Dairy-Creamery Department ($53,793.83) for 1945, although the net profits of the Cooperative were $2,889.27.

"We need not decide whether this accounting system satisfies the provisions of Paragraph 7 because the parties chose to abandon the contract as written and act under a modification thereof. It is not disputed that the Cooperative has at no time paid the dairymen in accordance with the provisions of Paragraph 7. It has made no effort to return to the dairymen, in accordance with that paragraph, the proceeds fairly attributable to the milk sold by them to the Cooperative, less appropriately attributable deductions.

"On the contrary, the Cooperative has, without exception, made flat payments to the dairymen periodically, without regard to the proceeds which would in fact be realized. Twice a month each dairyman was paid an amount computed by multiplying the amount of produce delivered to the Cooperative by a 'price' fixed by the officers of the Cooperative. This price was changed from time to time, as conditions varied. Similar periodic payments were made to other producers during the year. In addition, the net profits of the Cooperative at the end of each fiscal year were distributed annually. From the gross income of the entire Cooperative were subtracted all expenses of the entire Cooperative, including the amounts paid during the year to the producers for produce purchased by the Cooperative. The Cooperative never, in any year, distributed more than its net profits so computed."

After describing the method of computing the Cooperative's payments, the Court said:

"Since the parties to the contract have in fact followed this method of payment from the outset and have made no attempt to conform to the provisions of Paragraph 7, they must be deemed to have modified the written contract by mutual agreement. It is well established that parties to a contract can, by mutual agreement, modify or rescind a contract and adopt in its stead a new agreement. An agreement to change the terms of a contract may be shown by the conduct of the parties, as well as by evidence of an explicit agreement to modify. Appellee urges the asserted belief of the dairymen that they were selling under the provisions of

Paragraph 7 in opposition to a finding of modification by mutual consent. This opinion as to the interpretation of the written contract is not controlling. They knew the manner in which they were in fact being paid and acquiesced therein. They were aware that the periodic payments received by them during the year were at a flat rate on the amount of milk sold to the Cooperative. They knew the payments were irrevocable, even though they should ultimately exceed the net income allocated to them at the end of the year. In fact, in its first year of operation, 1940, the Dairy-Creamery Department apparently was run 'at a loss,' according to the books of the Cooperative, and the dairymen did not, nor were they requested to, repay the excess received.

"Similarly, despite their individual denials of actual knowledge, the dairymen cannot escape being charged with knowledge of the fact that the Cooperative was distributing annually only the profits of the entire Cooperative, not all the book profits of those departments showing a profit. They were aware that the Cooperative was organized to remain in business, not to bleed itself out of existence. They also knew, or should have known, that producers who appeared to have benefited from the ostensibly excessive payments by those departments which reflected a book loss were not required to repay the excess. They must, therefore, be charged with knowledge that this book loss was made up from the book profits of the other departments before the net profit of the Cooperative was distributed.

"The circumstances of the operation of the Cooperative demonstrate that the parties agreed to modify the written contract, substituting therefor another method of payment. The dairymen have in the past acquiesced in, and substantially benefited from, the payment methods to which they now object. Apparently one of the principal factors in converting the dairy department from a losing enterprise into a profitable one was the construction of the dairy-creamery plant at Anchorage. This construction was financed by the funds of the entire Cooperative. The cost apparently was not allocated to the Dairy Department, as distinguished from the other departments. This method of bookkeeping tends to exaggerate the amount of 'profits' attributable to the dairy products. Having benefited from this exaggeration each year in the past the dairymen should not now be permitted to repudiate the basic principles governing the operation of the Cooperative. The appellee should not be permitted to modify the contract when it is to his benefit to do so and then reinstate it and insist upon strict performance when that position would benefit him most. We think that is what he is attempting to do here." (Emphasis added.)

(R D. Burchard)

The Court here had a difficult choice in deciding that the formal legal agreements had been effectively superseded by the actual operating practice. This case should serve as a valuable reminder to all cooperatives to make an inspective analysis for the purpose of determining whether their existing operations conform with the terms of their legal papers.

If, as in this instance, it is an association's practice and policy to absorb a possible operating loss in one department by deductions from the returns of patrons in other departments, that fact could be incorporated clearly into the bylaws and the membership contracts and thus be made a formal part of the operating agreement. Doing so should produce a smoother relationship with and among members, and should lessen the area for disputes.

(George J. Waas)

SOCIAL SECURITY TAXES NOT APPLICABLE TO COTTON GINS OR THEIR EMPLOYEES

It has come to our attention that some misapprehension may have arisen regarding the applicability of the social security taxes to cotton gins and their employees.

A circular issued by the Bureau of Internal Revenue designated "Circular E" and entitled "Employees' Tax Handbook" bears date January 1951.

On page 6 of this circular appears a table that indicates that cotton gins are exempt from these taxes. This exemption is expressly contained in section 1426(b)(1)(B) of Title 26, U.S.C.

Previously and in October 1950, the Federal Security Agency issued a pamphlet containing the following statement (p. 42):

> "Employees of farm cooperatives handling any agricultural commodity, . . . are covered . . ."

At this point a conflict appears to have existed between pamphlets issued by the two agencies. However, in April 1951 the Federal Security Agency issued a pamphlet in which the broad statement contained in the October 1950 issue is corrected. The April 1951 pamphlet contains (p. 42) the following note:

> "Services performed in connection with cotton ginning . . . are not covered . . ."

Question arises as to whether cotton gins which have mistakenly made payments to the Bureau of Internal Revenue may recover the payments so made. These payments, like any other taxes erroneously paid, may

be recovered by filing a refund claim within the time required by law. It is suggested that if any organization has this problem it consult with the local representative of the Bureau of Internal Revenue.

It has also been inquired whether persons and organizations may voluntarily subject themselves to the provisions of the social security law. On this question the Federal Security Agency's pamphlet of April 1951 indicates that only the employees of certain organizations named in the law (previously excluded) may now voluntarily come within the law. The provision, however, is not broad enough to include cotton gins.

(R. D. Burchard)

It is noteworthy that the described exemption from social security taxes (under the Federal Insurance Contributions Act and the Federal Unemployment Tax Act), along with an exemption from the Federal income tax withholding regulations, is a privilege not accorded solely to cooperative associations but applies to any organization employing agricultural labor in connection with certain naval stores (turpentine and other oleoresinous products) and cotton ginning.

(George J. Waas)

TAXABILITY OF INHERITED INTEREST IN A FARMERS' COOPERATIVE WINE MARKETING POOL

On September 5, 1951, the Tax Court of the United States rendered a decision in Everett G. Maley v. Commissioner of Internal Revenue (17 T.C. No. 29).

The issues in this case did not directly involve a cooperative, but the case is of interest because the Court discussed the method of operating a pooling arrangement conducted by a farmers' marketing cooperative for the disposition of agricultural products.

Of the two issues considered by the Court, only the first one need concern us. The Court stated this issue as follows:

> "(1) Are the amounts the petitioner realized from proceeds received by him in the years 1944 and 1945 in liquidation of his inherited interest in a farmers' co-operative wine marketing pool which were in excess of his share of the estimated value of the pool for estate tax purposes taxable and, if so, are these amounts taxable as ordinary income or as capital gains?"

In deciding that the petitioner derived income from the receipt of pool payments and that such income should be taxed as capital gains in the

years in which they were received, the Court made the following comments, which have been excerpted from the opinion:

"The association commingled the decedent's grapes delivered to it pursuant to this [marketing] agreement with those of other farmer-members in a single pool, processed the grapes, and marketed the products derived therefrom in the following manner: The grapes were first delivered to the association's winery, where a record was made and kept of their weight, variety and sugar content as shown by tested samples of each lot delivered. From these records the relative shares of the members of the pool were computed in percentages of the whole annual crush of the association according to agreed adjustments with respect to the relative values of different grape varieties and of fruit of higher or lower sugar content. The association crushed the grapes and processed them into wine, brandy and certain by-products, and in so doing incurred expenses for such items as labor, fuel and power. The finished products were marketed by the association, after further outlays by it for packaging, taxes, freight, salaries, advertising and similar selling expenses. The association recouped such processing and marketing expenses on the first proceeds of the sale of the products of the particular pool for which these expenses were incurred. When further sale proceeds were received they were distributed from time to time to the members of each annual vintage pool according to each member's previously determined percentage of interest therein.

* * * * * * *

"The marketing agreement set out in our findings of fact, which the decedent, as a member of the Woodbridge Vineyard Association, entered into with that association, bound him for a period of five years to deliver wine grapes to the association for processing into wine to be sold by the association. While it might be argued that the language in this agreement to the effect that the 'member hereby sells and conveys' grapes, etc., and the language contained in the by-laws (incorporated into the contract by reference) to the effect that the grapes were to become the property of the association on delivery to it support the proposition that the parties intended a sale of grapes to take place, we believe that this language merely indicates the intent of the parties that legal title in such grapes was to pass on delivery to the association. Furthermore, we believe that the manner in which the association operated indicated that no sale was intended to take place. The agreement named no sales price, nor any method whereby a sales price could be determined, neither does the evidence show that the parties at any time intended that the members of the pool were to receive at some future time a reasonable value for the grapes delivered. The association did not even make any advances to its members on their delivery of grapes to it. It is clear that the parties intended that each member should deliver his crop of grapes to the pool,

bear his proportionate share of the expenses of the pool and, after the wine or other products were sold, receive his share of the profits, all of which were the property of the members of the pool.

"In similar cases where the question of the relationship between a marketing co-operative, organized under Chapter 4 of the Agricultural Code of California, and its members has arisen, the Courts have stated that this relationship is one of trust. California & Hawaiian Sugar Refining Corp, Ltd. v. Commissioner, 163 F. 2d 531; San Joaquin Valley Poultry Producers Association v. Commissioner, 136 F. 2d 382; Bogardus v. Santa Ana Walnut Growers Ass'n., 108 Pac. 2d 52 [Footnote omitted]. Accordingly, we hold that the relationship between the Woodbridge Vineyard Association and its members was not that of vendor and vendee and the parties did not contract for the sale of grapes by the members to the association.

"Since the producer-members did not sell their grapes to the association, it follows that after such grapes were delivered and became part of a certain wine pool each producer-member at all times retained an equitable interest in that pool in proportion to the quantity of grapes he had contributed and was entitled to his pro rata share of the profits realized from the sale of the products of that pool. It is also apparent that while the value of any producer-member's interest in a given pool might be estimated as of any given date, the amount of his profit or income could not be fixed until after the pool was liquidated, that is, after the wine and other products of the pool were sold and the processing, marketing and other expenses set off against such proceeds. On the date of petitioner's father's death in 1939 a substantial part of the 1937 pool, which contained his grapes, had not yet been liquidated. Petitioner and his sisters succeeded to their father's interest in this pool and a value was placed on such interest for Federal estate tax purposes. Liquidation of this pool took place thereafter during the period 1939-1945. The association during this period made payments to the petitioner of such liquidation proceeds and in 1944 and 1945 such payments, when added to previous payments, exceeded the 1939 fair market value of petitioner's inherited interest in the 1937 pool.

"From the foregoing consideration of the relationship between the decedent and the association and also the manner in which the association operated, it is apparent that the petitioner inherited from his father not merely an equitable interest in the 1937 pool measured by the value of the wine and other products at whatever stage of development they were in in 1939 but also the right to share in a certain percentage of any profits which would be realized over a period of years from the sales by the association, in the normal course of its business, of the finished products of

this particular pool. It is also apparent that in the process of liquidating the pool, the sales of the wine and other products were made by the association on behalf of the members and the proceeds of such sales were returned to the members after expenses were deducted therefrom.

"It follows that part of the 1944 and all of the 1945 liquidation proceeds received by the petitioner represent an increment over and above the value of his interest in the pool acquired in 1939. Accordingly, we hold these amounts, $426.65 received in 1944 and $323.88 received in 1945, constitute taxable gains to the petitioner in those years.

"The taxability of such gains realized by the petitioner as capital gains depends on the question as to whether the petitioner's interest was a capital asset. 'Capital assets' are defined in the Code as follows:

> "SEC. 117. CAPITAL GAINS AND LOSSES.
>
> "(a) Definitions. - As used in this title -
>
> "(1) Capital Assets. - The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), or real property used in the trade or business of the taxpayer;

"It appears that the interest of the petitioner acquired by inheritance in this particular wine pool is independent of petitioner's operation of his father's vineyard in partnership with his sisters, and is independent of any membership he himself may have later acquired in the association, and does not fall within the exclusions of section 117 of the Code. The petitioner's interest was, therefore, a capital asset held for more than six months and the gains realized on the distribution are taxable as a long-term capital gain in each of the years in which such gains were realized, and we so hold."

(R. D. Burchard)

In the case of the Broadcast Measurement Bureau, Inc., v. Commissioner of Internal Revenue, 1/ the Tax Court on May 10, 1951 (16 T.C.122) in rendering a decision favorable to the petitioner relied upon the testimony of the two contractual parties to clarify the vagueness of a written cooperative agreement. The Maley case, here discussed, has a somewhat similar element in that the Court looked through the actual language in the cooperative's bylaws and other papers, and, by the application of cooperative principles, determined to its own satisfaction that "the relationship between the Woodbridge Vineyard Association and its members was not that of vendor and vendee."

Once again there is illustrated the importance of wording the legal papers in such a way as to portray, without ambiguity, the true cooperative relationship. In these two cases only the astuteness of the Court prevented a vital misinterpretation.

Although it did not affect the main issue, the Court, in the Maley case, inappropriately used the word profits in connection with the affairs of the cooperative winery. In actuality, a marketing cooperative operating with a pooling system receives sales proceeds and distributes them to members after deduction of operating expenses. In no conceivable sense can the sales proceeds be regarded as profits of the association. Even the member who is paid a distributive share of the sales proceeds, receives thereby only gross income from which he must deduct farming costs and expenses before his own profit is revealed.

(George J. Waas)

1/ As reported in Summary No. 50, June 1951, p. 4, et al.